

CHAPTER 9

OBSERVATIONS/RECOMMENDATIONS OF THE COMMITTEE

The observations/recommendations of the Committee are summarised below:

Meaning of Capital Account Convertibility

1. Currency convertibility refers to the freedom to convert the domestic currency into other internationally accepted currencies and *vice versa*. Convertibility in that sense is the obverse of controls or restrictions on currency transactions. While current account convertibility refers to freedom in respect of 'payments and transfers for current international transactions', capital account convertibility (CAC) would mean freedom of currency conversion in relation to capital transactions in terms of inflows and outflows. The cross-country experience with capital account liberalisation suggests that countries, including those which have an open capital account, do retain some regulations influencing inward and outward capital flows. For the purpose of this Committee, the working definition of CAC would be as follows:

CAC refers to the freedom to convert local financial assets into foreign financial assets and *vice versa*. It is associated with changes of ownership in foreign/domestic financial assets and liabilities and embodies the creation and liquidation of claims on, or by, the rest of the world. CAC can be, and is, coexistent with restrictions other than on external payments. (Paragraphs 2.1 - 2.3)

Changing International and Emerging Market Perspectives

2. There is some literature which supports a free capital account in the context of global integration, both in trade and finance, for enhancing growth and welfare. The perspective on CAC has, however, undergone some change following the experiences of emerging market economies (EMEs) in Asia and Latin America which went through currency and banking crises in the 1990s. A few countries backtracked and re-imposed some capital controls as part of crisis resolution. While there are economic, social and human costs of crisis, it has also been argued that extensive presence of capital controls, when an economy opens up the current account, creates distortions, making them either ineffective or unsustainable. The costs and benefits or risks and gains from capital account liberalisation or controls are still being debated among both academics and policy makers. These developments have led to considerable caution being exercised by EMEs in opening up the capital account. The link between capital account liberalisation and growth is yet to be firmly established by empirical research. Nevertheless, the mainstream view holds that capital account liberalisation can be beneficial when countries move in tandem with a strong macroeconomic policy framework, sound financial system and markets, supported by prudential regulatory and supervisory policies. (Paragraphs 2.4 - 2.5)

Objectives and Significance of Fuller Capital Account Convertibility (FCAC) in the Indian Context

3. India has cautiously opened up its capital account since the early 1990s and the state of capital controls in India today can be considered as the most liberalised it has ever been in its history since the late 1950s. Nevertheless, several capital controls continue to persist. In this context, an FCAC would signify the additional measures which could be taken in furtherance of CAC and in that sense, 'Fuller Capital Account Convertibility' would not necessarily mean zero capital regulation. In this context, the analogy to *de jure* current account convertibility is pertinent. *De jure* current account convertibility recognises that there would be reasonable limits for certain transactions, with 'reasonableness' being perceived by the user. FCAC is not an end in itself, but should be treated only as a means to realise the potential of the economy to the maximum possible extent at the least cost. Given the huge investment needs of the country and that domestic savings alone will not be adequate to meet this aim, inflows of foreign capital become imperative. The inflow of foreign equity capital can be in the form of portfolio flows or foreign direct investment (FDI). FDI tends to be also associated with non-financial aspects, such as transfer of technology, infusion of management and supply chain practices, etc. In that sense, it has greater impact on growth. The objectives of an FCAC are: (i) to facilitate economic growth through higher investment by minimising the cost of both equity and debt capital; (ii) to improve the efficiency of the financial sector through greater competition, thereby minimising intermediation costs and (iii) to provide opportunities for diversification of investments by residents. (Paragraphs 2.6 - 2.8)

Some Lessons from the Currency Crises in Emerging Market Economics

4. The risks of FCAC arise mainly from inadequate preparedness before liberalisation in terms of domestic and external sector policy consolidation, strengthening of prudential regulation and development of financial markets, including infrastructure, for orderly functioning of these markets. Most currency crises arise out of prolonged overvalued exchange rates, leading to unsustainable current account deficits. A transparent fiscal consolidation is necessary and desirable, to reduce the risk of currency crisis. Short-term debt flows react quickly and adversely during currency crises. Domestic financial institutions, in particular banks, need to be strong and resilient. The quality and proactive nature of market regulation is also critical to the success of efficient functioning of financial markets during times of currency crises. (Paragraphs 2.9 - 2.11)

Committee's Approach to FCAC and Related Issues

5. The status of capital account convertibility in India for various non-residents is as follows: for foreign corporates, and foreign institutions, there is a reasonable amount of convertibility; for non-resident Indians (NRIs) there is approximately

an equal amount of convertibility, but one accompanied by severe procedural and regulatory impediments. For non-resident individuals, other than NRIs, there is near-zero convertibility. Movement towards an FCAC implies that all non-residents (corporates and individuals) should be treated equally. This would mean the removal of the tax benefits presently accorded to NRIs via special bank deposit schemes for NRIs, viz., Non-Resident External Rupee Account [NR(E)RA] and Foreign Currency Non-Resident (Banks) Scheme [FCNR(B)]. The Committee recommends that the present tax benefit for these special deposit schemes for NRIs, [NR(E)RA and FCNR(B)], should be reviewed by the Government. Non-residents, other than NRIs, should be allowed to open FCNR(B) and NR(E)RA accounts without tax benefits, subject to Know Your Customer (KYC) and Financial Action Task Force (FATF) norms. In the case of the present NRI schemes for various types of investments, other than deposits, there are a number of procedural impediments and these should be examined by the Government and the RBI. (Paragraph 2.12)

6. It would be desirable to consider a gradual liberalisation for resident corporates/business entities, banks, non-banks and individuals. The issue of liberalisation of capital outflows for individuals is a strong confidence building measure, but such opening up has to be well calibrated as there are fears of waves of outflows. The general experience is that as the capital account is liberalised for resident outflows, the net inflows do not decrease, provided the macroeconomic framework is stable. (Paragraph 2.14)

7. As India progressively moves on the path of an FCAC, the issue of investments being channelled through a particular country so as to obtain tax benefits would come to the fore as investments through other channels get discriminated against. Such discriminatory tax treaties are not consistent with an increasing liberalisation of the capital account as distortions inevitably emerge, possibly raising the cost of capital to the host country. With global integration of capital markets, tax policies should be harmonised. It would, therefore, be desirable that the Government undertakes a review of tax policies and tax treaties. (Paragraph 2.15)

8. A hierarchy of preferences may need to be set out on capital inflows. In terms of type of flows, allowing greater flexibility for rupee denominated debt which would be preferable to foreign currency debt, medium and long term debt in preference to short-term debt, and direct investment to portfolio flows. There are reports of large flows of private equity capital, all of which may not be captured in the data (this issue needs to be reviewed by the RBI). There is a need to monitor the amount of short-term borrowings and banking capital, both of which have been shown to be problematic during the crisis in East Asia and in other EMEs. (Paragraphs 2.17)

9. Greater focus may be needed on regulatory and supervisory issues in banking to strengthen the entire risk management framework. Preference should be given to control volatility in cross-border capital flows in prudential policy measures. Given the importance that the commercial banks occupy in the Indian financial system, the banking system should be the focal point for appropriate prudential policy measures. (Paragraph 2.18)

Broad Framework for Timing, Phasing and Sequencing of Measures

10. On a review of existing controls, a broad time frame of a five year period in three phases, 2006-07 (Phase I), 2007-08 and 2008-09 (Phase II) and 2009-10 and 2010-11 (Phase III) has been considered appropriate by the Committee. This enables the authorities to undertake a stock taking after each Phase before moving on to the next Phase. The roadmap should be considered as a broad time-path for measures and the pace of actual implementation would no doubt be determined by the authorities' assessment of overall macroeconomic developments as also specific problems as they unfold. There is a need to break out of the "control" mindset and the substantive items subject to capital controls should be separated from the procedural issues. This will enable a better monitoring of the capital controls and enable a more meaningful calibration of the liberalisation process. (Paragraph 2.20)

Liberalisation of the Capital Account Since 1997

11. The action taken on the 1997 Committee Report is set out in Annex III provided by the RBI. This does bring out that by and large the RBI has taken action on a number of recommendations but the extent of implementation has been somewhat muted on some of the proposed measures (e.g., outflows by resident individuals and overseas borrowing by banks), while for some other measures, the RBI has proceeded far beyond the Committee's recommendations (e.g. outflows by resident corporates). RBI has, however, taken a number of additional measures outside the 1997 Committee's recommendations. (Paragraph 3.10)

12. The core of the capital account liberalisation measures proposed by the 1997 Committee were essentially in relation to residents. While resident corporates have been provided fairly liberal limits, the liberalisation for resident individuals has been hesitant and in some cases inoperative because of procedural impediments. (Paragraph 3.19)

13. In a tightly regulated regime, with a myriad of specific schemes and controls, the monitoring was related to these individual schemes. While there has, no doubt, been a fair amount of liberalisation, the basic framework of the control system has remained unchanged. The RBI has liberalised the framework on an *ad hoc* basis and the liberalised framework continues to be a prisoner of the erstwhile strict control system. Progressively, as capital account liberalisation gathers pace it is imperative that there

should be a rationalisation/simplification of the regulatory system and procedures in a manner wherein there can be a viable and meaningful monitoring of the capital flows. The Committee recommends that there should be an early rationalisation/consolidation of the various facilities. Furthermore, it is observed that with the formal adoption of current account convertibility in 1994 and the subsequent gradual liberalisation of the capital account, some inconsistencies in the policy framework have emerged and the Committee recommends that these issues should be comprehensively examined by the RBI. (Paragraph 3.21)

Concomitants for a Move to Fuller Capital Account Convertibility

14. While a certain extent of capital account liberalisation has taken place, since 1997, it would be necessary to set out a broad framework for chalking out the sequencing and timing of further capital account liberalisation. The key concomitants discussed below are not in any order of priority. (Paragraph 4.3)

Fiscal Consolidation

15. The Fiscal Responsibility and Budget Management (FRBM) Legislation was enacted in 2003 and the Rules were notified in 2004. Steps are required to be taken to reduce the fiscal and revenue deficits and the revenue deficit was to be eliminated by March 31, 2008 and adequate surpluses were to be built up thereafter. The target for reducing the Centre's fiscal deficit to 3 per cent of GDP and elimination of the revenue deficit has been extended by the Central Government to March 31, 2009. The Twelfth Finance Commission (TFC) recommended that the revenue deficits of the States should be eliminated by 2008-09 and that the fiscal deficits of the States should be reduced to 3 per cent of GDP. (Paragraphs 4.4 - 4.5)

16. The Committee notes that apart from market borrowings, at the general government level, there are several other liabilities of governments – both explicit and implicit - such as small savings and unfunded pension liabilities which are large but not easily quantifiable. As the interest rate conditions and climate for investment and growth are dependent upon the totality of such resource dependence, generation of revenue surplus to meet repayment of the marketable debt should be viewed but as a first step towards fiscal prudence and consolidation. A large fiscal deficit makes a country vulnerable. In an FCAC regime, the adverse effects of an increasing fiscal deficit and a ballooning internal debt would be transmitted much faster and, therefore, it is necessary to moderate the public sector borrowing requirement and also contain the total stock of liabilities. (Paragraph 4.6)

17. The system of meeting government's financing needs is set out in terms of *net* borrowing, i.e., the *gross* borrowing minus repayments. This masks the repayment issue totally as no arrangement is made for the repayment. This approach of financing

repayments out of fresh borrowings poses the danger of a vicious cycle of higher market borrowings at a relatively higher cost, chasing higher repayments. While repayment obligations financed through gross borrowings would not affect the gross fiscal deficit for the particular year of borrowings, the concomitant interest burden would fuel the revenue deficit as well as the gross fiscal deficit in subsequent years. This development would not only result in higher accumulation of debt but also further aggravate the problem of debt sustainability. (Paragraph 4.7)

18. With the progressive move to market determined interest rates on government securities and the dilution of the captive market, there is no certainty that repayments would smoothly and automatically be met out of fresh borrowings without a pressure on real interest rates. Progressively, therefore, it is the *gross* borrowing programme and not the *net* borrowing programme which has to be related to the absorptive capacity of the market as also in gauging potential borrowing costs of the government. The Committee recommends that a substantial part of the revenue surplus of the Centre should be earmarked for meeting the repayment liability under the Centre's market borrowing programme, thereby reducing the *gross* borrowing requirement. (Paragraph 4.8)

19. The Committee recommends that as part of better fiscal management, the Central Government and the States should graduate from the present system of computing the fiscal deficit to a measure of the *Public Sector Borrowing Requirement (PSBR)*. The PSBR is a more accurate assessment of the fisc's resource dependence on the economy. Rough indications point to the probability of the PSBR being about 3 per cent of GDP above the fiscal deficit. The RBI should attempt a preliminary assessment of the PSBR and put it in the public domain which would then facilitate the adoption of the PSBR as a clearer indicator of the public sector deficit. (Paragraph 4.9)

20. For an effective functional separation enabling more efficient debt management as also monetary management, the Committee recommends that the Office of Public Debt should be set up to function independently outside the RBI. (Paragraph 4.10)

Monetary Policy Objectives

21. In the rapidly changing international environment and the drawing up of a roadmap towards fuller capital account convertibility, the issue of greater autonomy for monetary policy needs to be revisited. The Committee recommends that, consistent with overall economic policy, the RBI and Government should jointly set out the objectives of monetary policy for a specific period and this should be put in the public domain. Once the monetary policy objectives are set out, the RBI should have unfettered instrument independence to attain the monetary policy objectives. Given the lagged impact of monetary policy action, the monetary policy objectives should have a medium-term perspective. The Committee recommends that the proposed system of setting objectives

should be initiated from the year 2007-08. Strengthening the institutional framework for setting monetary policy objectives is important in the context of an FCAC. The RBI has instituted a *Technical Advisory Committee on Monetary Policy*. While this is a useful first step, the Committee recommends that a formal Monetary Policy Committee should be the next step in strengthening the institutional framework. At some appropriate stage, a summary of the minutes of the Monetary Policy Committee should be put in the public domain with a suitable lag. -(Paragraphs 4.13 - 4.15)

Strengthening of the Banking System

22. On the strengthening of the banking system, the Committee has the following recommendations:

- (i) All commercial banks should be subject to a single Banking Legislation and separate legislative frameworks for groups of public sector banks should be abrogated. All banks, including public sector banks, should be incorporated under the Companies Act; this would provide a level playing field.
- (ii) The minimum share of Government/RBI in the capital of public sector banks should be reduced from 51 per cent (55 per cent for SBI) to 33 per cent as recommended by the Narasimham Committee on Banking Sector Reforms (1998). There are, admittedly, certain social objectives in the very nature of public sector banking and a reduction in the Government/RBI holding to 33 per cent would not alter the positive aspects in the public sector character of these banks.
- (iii) With regard to the proposed transfer of ownership of SBI from the RBI to government, the Committee recommends that given the imperative need for strengthening the capital of banks in the context of Basel II and FCAC, this transfer should be put on hold. This way the increased capital requirement for a sizeable segment of the banking sector would be met for the ensuing period. The Committee, however, stresses that the giving up of majority ownership of public sector banks should be worked out both for nationalised banks and the SBI.
- (iv) In the first round of setting up new private sector banks, those private sector banks which had institutional backing have turned out to be the successful banks. The authorities should actively encourage similar initiative by institutions to set up new private sector banks.
- (v) Until amendments are made to the relevant statutes to promote consolidation in the banking system and address the capital requirements of the public sector banks, the RBI should evolve policies to allow, on a case by case basis, industrial houses to have a stake in Indian banks or promote new banks. The policy may also encourage non-banking finance

companies to convert into banks. After exploring these avenues until 2009, foreign banks may be allowed to enhance their presence in the banking system.

- (vi) Issues of corporate governance in banks, powers of the Boards of public sector banks, remuneration issues, hiring of personnel with requisite skills in specialised functions and succession planning need early attention.
- (vii) The voting rights of the investors should be in accordance with the provisions of the Companies Act.
- (viii) Following the model of the comprehensive exercise undertaken on Transparency, a number of Groups/Committees could be set up for examining each set of issues under the overall guidance/coordination of a High Level Government – RBI Committee to ensure concerted and early action to expeditiously prepare the financial system to meet the challenges in the coming years in the context of Basel II and the move to an FCAC. As part of this comprehensive exercise, the proposed Committee should revisit the issue of investments by foreign banks in Indian banking. In this Committee's view, this has relevance in the context of issues relating to bank recapitalisation, governance, induction of technology and weak banks. (Paragraph 4.26)

External Sector Indicators

23. Given the present CR/GDP ratio of 24.5 per cent, the CR/CP ratio of 95 per cent and a debt service ratio in the range of 10-15 per cent, a CAD/GDP ratio of 3 per cent could be comfortably financed. Should the CAD/GDP ratio rise substantially over 3 per cent there would be a need for policy action. (Paragraphs 4.28 - 4.30, 4.32)

24. In terms of total external liabilities, which include portfolio liabilities, India's reserves cover over one half of the external liabilities. In the context of large non-debt flows in recent years, greater attention is required to the concept of reserve adequacy in relation to external liabilities. (Paragraph 4.34)

25. While the reserves are comfortable in relation to various parameters, the Committee has some concerns about the coverage of data on short-term debt, including suppliers' credit. Again there are concerns whether the flow of private equity capital are fully captured in the data (on FDI). The Committee suggests that the RBI should undertake an in-depth examination of the coverage and accuracy of these data. (Paragraph 4.35)

Monetary Policy Instruments and Operations

26. The sterilisation and open market operations (OMO) and interventions in the forex markets have to be so calibrated along with domestic monetary instruments so as to be consistent with the monetary policy objectives. A major objective of monetary policy is containing inflationary expectations and to attain this objective, monetary policy action needs to be undertaken well before the economy reaches the upper turning point of the cycle. If the measures are delayed, small incremental changes are ineffective and moreover could be destabilising, particularly if monetary tightening is undertaken during the downturn of the cycle. With transparency in setting objectives, there would be improved credibility if the RBI had greater independence in optimising the use of instruments and operating procedures. (Paragraphs 5.5 and 5.7)

27. Given the nascent state of development of market based monetary policy instruments and the size of capital flows, it would be necessary to continue to actively use the instrument of reserve requirements. (Paragraph 5.8)

28. The LAF should be essentially an instrument of equilibrating very short-term liquidity. The Committee recommends that, over time, the RBI should build up its stocks of government securities so as to undertake effective outright OMO. (Paragraph 5.9)

29. The interest cost of sterilisation to the Government and the RBI in 2005-06 is reported to be in the broad range of Rs.4,000 crore (though reduced somewhat by corresponding earnings on the forex reserves). While the costs of sterilisation are often highlighted, the costs of non-intervention and non-sterilisation are not easily quantifiable as the costs are in terms of lower growth, lower employment, loss of competitiveness of India, lower corporate profitability and lower government revenues; these costs could be much more than the visible costs of sterilisation. (Paragraph 5.10)

30. While appreciating the RBI's dilemma of a shortage of instruments, the Committee recommends the following:

- (i) The RBI should activate variable rate repo/reverse repo auctions or repo/reverse repo operations on a real time basis.
- (ii) RBI should consider somewhat longer-term LAF facilities.
- (iii) To the extent the RBI assesses the excess liquidity to be more than transient, it should also use the cash reserve ratio (CRR) and Statutory Liquidity Ratio (SLR). Where there is a large increase in liquidity and credit expansion way above the trend line, bank profitability is higher and the banks can be legitimately expected to bear a part of the burden of containing the deleterious expansion of liquidity. The Committee recognises that the CRR cannot be as effective as in earlier years as banks are anyway maintaining large balances for settlement operations. Nonetheless, it can be a supportive instrument and the entire

burden should not be on the LAF and the Market Stabilisation Scheme (MSS).

- (iv) To the extent the capital inflows are exceptionally high and the economy is inundated with excess liquidity, arising out of FII inflows, the authorities may consider, in very exceptional circumstances, the imposition of an unremunerated reserve requirement on fresh FII inflows. The Committee recommends that measures of such a nature should be exceptional, to be used only in extreme situations wherein the liquidity arising out of extremely large and volatile FII inflows reaches unmanageable proportions. Furthermore, such a measure, to be effective, should be used as a temporary measure only for a few months. (Paragraph 5.11)

Exchange Rate Management

31. The articulation of the exchange rate policy gives the Committee some concern. The authorities have centred the articulation of the exchange rate policy on managing *volatility*. The Committee is of the view that apart from volatility what is more important is the *level* of the exchange rate. The Committee recommends that work needs to be undertaken by the RBI to refine the REER index by incorporation of services to the extent possible. Furthermore, for periods where there are large import duty adjustments, these should be built into the construction of the REER. According to the RBI, these indices are constructed “as part of its communication policy and to aid researchers and analysts”. The Committee would, however, stress that the REER should also be a valuable input into the formulation of the RBI’s exchange rate policy. (Paragraphs 5.12 - 5.13)

32. The 1997 Committee recommended that:

“The RBI should have a Monitoring Exchange Rate Band of +/- 5.0 per cent around the neutral REER. The RBI should ordinarily intervene as and when the REER is outside the band. The RBI should ordinarily not intervene when the REER is within the band. The RBI could, however, use its judgment to intervene even within the band to obviate speculative forces and unwarranted volatility. The Committee further recommends that the RBI should undertake a periodic review of the neutral REER which could be changed as warranted by fundamentals.”

The present Committee endorses the recommendations of the 1997 Committee. (Paragraph 5.14)

33. The Committee recommends that, as an operative rule, if the CAD persists beyond 3 per cent of GDP (referred as an outer sustainable limit, at the present time) the exchange rate policy should be reviewed. (Paragraph 5.15)

Development of Financial Markets

34. Any country intending to introduce an FCAC needs to ensure that different market segments are not only well developed but also that they are well integrated. Otherwise, shocks to one or more market segments would not get transmitted to other segments efficiently so that the entire financial system is able to absorb the shocks with minimal damage. Broadly, there are three main dimensions of a well developed financial system. These are: (i) vibrancy and strength of the physical infrastructure of markets as reflected by the IT systems, communication networks, business continuity and disaster management capabilities, (ii) the skill and competency levels of people who man the offices of financial intermediaries like commercial and investment banks, institutions that manage trading platforms and clearing and settlement arrangements and market intermediaries like brokerage houses, etc. and (iii) quality of regulatory and supervisory arrangements. (Paragraph 6.4)

Equity Market

35. Indian equity market consists of primary and secondary segments, both of which have evolved to world class standards in terms of trading technology, disclosure standards and price discovery processes. Foreign institutional holding has risen to about 10 to 15 per cent of the market capitalisation, which itself is now approaching 100 per cent of GDP. In terms of trading intensity and liquidity, Indian stock exchanges are among the world's best. (Paragraph 5.16)

Money Market

36. The Committee's recommendations relating to development of the money market are set out in Paragraph 6.18 (i) - (xii).

Government Securities Market

37. The Committee's recommendations for further development of the government securities market are set out in Paragraph 6.24 (i) - (viii).

Corporate Bond Market

38. The Committee's recommendations for the development of the corporate bond and securitised debt market are set out in Paragraph 6.31 (i) - (x).

Foreign Exchange Market

39. The Committee's recommendations for the development of the forex market are set out in Paragraph 6.42 (i) - (vii).

Gold Market

40. The Committee's recommendations for the development of the gold market are set out in Paragraph 6.43 (i) - (vii).

Regulatory and Supervisory Issues in Banking

41. Under an FCAC regime, the banking system will be exposed to greater market volatility. Hence, it is necessary to address the relevant issues in the banking system including the regulatory and supervisory aspects to enable the system to become more resilient to shocks and sustain their operations with greater stability. (Paragraph 7.1)

42. In a new environment, the commercial banks should be able to manage multi-dimensional operations in situations of both large inflows and outflows of capital. In particular, their own exposures to exchange rate risk, coupled with their exposures to corporates which are exposed to similar risks, panning across national jurisdictions add to the multiplicity of risks which need to be closely monitored and prudently managed. The RBI, therefore, needs to review the prudential standards applicable to commercial banks and should consider making the regulations activity-specific, instead of keeping them institution-specific. (Paragraph 7.5)

Dimensions of Risks

43. Going forward, opening up of the system is expected to result in larger two-way flows of capital in and out of the country; this underscores the need for enhancing the risk management capabilities in the banking system. The risk elements which will become more prominent than at present are set out in Paragraph 7.8 (i) - (vii).

Prudential Regulation

44. Issues in prudential regulation are set out in Paragraph 7.10 (i) - (xi).

Supervisory Practices

45. The supervisory issues which need attention are set out in Paragraph 7.12 (i) - (vi).

46. As the country moves to an FCAC regime, it is necessary to improve relevant regulatory and supervisory standards across the banking system to enable them to become more resilient and sustain their operations with greater stability. The key

requirements in this regard would be: robust and sophisticated risk management systems in banks supplemented by a regimen of appropriate stress testing framework; efficient and reliable IT systems providing on-line data to support the risk management systems in banks; robust accounting and auditing framework; adoption of economic capital framework and risk-based allocation of capital; upgradation of skills; upgradation of IT-based surveillance systems and manpower skills in the RBI; fuller compliance with Anti-money Laundering (AML)/Know Your Customer (KYC) and Financial Action Task Force (FATF) requirements; and a need for prescription of a limit on the off-balance sheet items with reference to balance sheet size. (Paragraph 7.13)

47. The tabular material attached to Chapter 7 sets out the proposed measures for strengthening regulation and supervision in the banking sector. (Paragraph 7.13).

Timing and Sequencing of Measures for Fuller Capital Account Convertibility

48. Before discussing the recommended framework on the timing and sequencing of specific capital account liberalisation measures, it would perhaps be useful to refer to a few general issues. First, there are a number of items which straddle the current and capital accounts and items in one account have implication for the other account. Inconsistencies in the regulations of such items need to be ironed out. Secondly, while there is *de jure* current account convertibility, there are time-honoured stipulations which require surrender requirements for export proceeds. Surrender requirements, *per se*, are consistent with current account convertibility, but as part of overall management of the current and capital flows, it would be useful to consider whether the repatriation/surrender requirements could be gradually eased. Thirdly, there are a number of items where there are anomalous stipulations which date back to a very restrictive period. Illustratively, investments by NRIs in CPs are non-repatriable. It is not clear whether the sale proceeds of the CP are non-repatriable or whether they can be credited to a repatriable account; either way, a non-resident can make a remittance out of an NRO account. In other words, regulations of a period of extremely tight current and capital controls continue to remain even though the overall regime has undergone a significant degree of liberalisation. Fourthly, the knots in the forex management system need to be untied before the liberalisation can become meaningful. The Committee recommends that a *RBI Task Force* should be set up immediately to identify the anomalies in the present regulatory framework for the current and capital accounts and the rectification should be undertaken within a period of three months. (Paragraph 8.1)

49. On an examination of the extant regulations relating to the capital account, as set out by the RBI in Annex III, the Committee is of the view that the extant matrix is a mixed bag of policy measures and procedural/operational matters. The Committee has, therefore, separated the extant regulations into policy issues and

procedural/operational matters and a list of items has been prepared by the Committee to be reviewed by the RBI. The Committee recommends that the items identified as procedural/operational matters should be reviewed by the RBI Task Force referred to above. The RBI Task Force should also review the delegation of powers on foreign exchange regulation as between the Central Office and the Regional Offices of the RBI and *inter alia*, examine, selectively, the efficacy in the functioning of the delegation of powers by the RBI to ADs. (Paragraph 8.2)

50. As regards the substantive regulations on the capital account, the Committee recommends a five-year roadmap with three phases on the timing and sequencing of measures. These are set out in the Tabular Material in Chapter 8. (Paragraph 8.3)

51. Some of the significant measures are set out below:

- (i) The Committee recommends that the overall ECB ceiling as also the ceiling for automatic approval should be gradually raised. Rupee denominated ECB (payable in foreign currency) should be outside the ECB ceiling. ECBs of over 10-year maturity in Phase I and over 7-year maturity in Phase II should be outside the ceiling. End-use restriction should be removed in Phase I.
- (ii) The Committee has concerns about the volume of trade credit as there could be sudden changes in the availability of such credit. Furthermore, there are concerns as to whether the trade credit numbers are fully captured in the data even while noting that suppliers' credit of less than 180 days are excluded from these data. Import-linked short-term loans should be monitored in a comprehensive manner. The per transaction limit of US\$ 20 million should be reviewed and the scheme revamped to avoid unlimited borrowing.
- (iii) Recognising that Indian industry is successfully building up its presence abroad, there is a strong case for liberalising the present limits for corporate investment abroad. The Committee recommends that the limits for such outflows should be raised in phases from 200 per cent of net worth to 400 per cent of net worth. As part of a rationalisation, these limits should also subsume a number of other categories (detailed in the Matrix); furthermore, for non-corporate businesses, it is recommended that the limits should be aligned with those for corporates.
- (iv) Although EEFC Accounts are permitted in the present framework, these facilities do not effectively serve the intended purpose. The Committee recommends that EEFC Account holders should be provided foreign currency current/savings accounts with cheque writing facility and interest

bearing term deposits. In practice some banks are erroneously providing cheque writing facilities only in rupees.

- (v) Project exports should be provided greater flexibility and these facilities should be also provided for service exports.
- (vi) In the case of Participatory Notes (PNs), the nature of the beneficial ownership or the identity is not known unlike in the case of FIIIs. These PNs are freely transferable and trading of these instruments makes it all the more difficult to know the identity of the owner. It is also not possible to prevent trading in PNs as the entities subscribing to the PNs cannot be restrained from issuing securities on the strength of the PNs held by them. The Committee is, therefore, of the view that FIIIs should be prohibited from investing fresh money raised through PNs. Existing PN-holders may be provided an exit route and phased out completely within one year.
- (vii) The Committee recommends that non-resident corporates should be allowed to invest in the Indian stock markets through SEBI-registered entities including mutual funds and Portfolio Management Schemes who will be individually responsible for fulfilling KYC and FATF norms. The money should come through bank accounts in India.
- (viii) At present, only multilateral institutions are allowed to raise rupee bonds in India. To encourage, selectively, the raising of rupee denominated bonds, the Committee recommends that other institutions/corporates should be allowed to raise rupee bonds (with an option to convert into foreign exchange) subject to an overall ceiling which should be gradually raised.
- (ix) The banks' borrowing facilities are at present restrictive though there are various special facilities which are outside the ceiling. The Committee recommends that the limits for borrowing overseas should be linked to paid-up capital and free reserves, and not to unimpaired Tier I capital, as at present, and raised substantially to 50 per cent in Phase I, 75 per cent in Phase II and 100 per cent in Phase III. Ultimately, all types of external liabilities of banks should be within an overall limit.
- (x) At present, only mutual funds are permitted to invest overseas subject to stipulations for each fund. The Committee recommends that the various stipulations on individual fund limits and the proportion in relation to NAV should be abolished. The overall ceilings should be raised from the present level of US\$ 2 billion to US\$ 3 billion in Phase I, to US\$ 4 billion in Phase II and to US\$ 5 billion in Phase III. The Committee further recommends that these facilities should be available, apart from Mutual Funds, to SEBI registered portfolio management schemes.

- (xi) The present facility for individuals to freely remit US\$ 25,000 per calendar year enables individuals to open foreign currency accounts overseas. The Committee recommends that this annual limit be successively raised to US\$ 50,000 in Phase I, US\$ 100,000 in Phase II and US\$ 200,000 in Phase III. Difficulties in operating this scheme should be reviewed. Since this facility straddles the current and capital accounts, the Committee recommends that where current account transactions are restricted, i.e., gifts, donations and travel, these should be raised to an overall ceiling of US\$ 25,000 without any sub-limit.
- (xii) Residents can at present invest, without any limit, directly in such overseas companies as have a shareholding of at least 10 per cent in an Indian company. This facility is cumbersome to operate and in the context of the large increase in limits for individuals proposed under (i) above, the Committee recommends that this facility should be abolished.
- (xiii) The Committee recommends that the RFC and RFC(D) Accounts should be merged. The account holders should be given general permission to move the foreign currency balances to overseas banks; those wishing to continue RFC Accounts should be provided foreign currency current/savings chequable accounts in addition to foreign currency term deposits.
- (xiv) At present only NRIs are allowed to maintain FCNR(B) and NR(E)RA deposits. The Committee recommends that non-residents (other than NRIs) should also be allowed access to these deposit schemes. Since NRIs enjoy tax concessions on FCNR(B) and NR(E)RA deposits, it would be necessary to provide FCNR(B)/NR(E)RA deposit facilities as separate and distinct schemes for non-residents (other than NRIs) without tax benefits. In Phase I, the NRs (other than NRIs) could be first provided the FCNR(B) deposit facility, without tax benefits, subject to KYC/FATF norms. In Phase II, the NR(E)RA deposit scheme, with cheque writing facility, could be provided to NRs (other than NRIs) without tax benefits after the system has in place KYC/FATF norms. The present tax regulations on FCNR(B) and NR(E)RA deposits for NRIs should be reviewed by the government.
- (xv) At present, only NRIs are allowed to invest in companies on the Indian stock exchanges subject to certain stipulations. The Committee recommends that all individual non-residents should be allowed to invest in the Indian stock market through SEBI registered entities including mutual funds and Portfolio Management Schemes who will be responsible for meeting KYC and FATF norms and that the money should come through bank accounts in India. (Paragraph 8.6)

52. The Committee recommends that at the end of the five-year period ending in 2010-11, there should be a comprehensive review to chalk out the future course of action. (Paragraph 8.3)

July 25, 2006

Mr. A.V.Rajwade
2, Parshwakunj,
Malaviya Road,
Vile Parle (East),
Mumbai 400 057.

Chairman
Committee on Fuller Capital Account Convertibility
C/o Reserve Bank of India
Mumbai.

Dear Sir,

Report of CFCAC

I have reservations about some of the recommendations in the report. These are discussed in the following paragraphs:

1. Recommendation I.B.2, **P-notes**. The report recommends the banning of fresh inflows in the form of participatory notes. I feel that as the Lahiri Committee has gone into the issue in more detail, its views should be respected.
2. Recommendation III.B.1(d), **FII investment in the bond market**. The Committee has recommended a progressively increasing ceiling on the investment in the rupee bond market. In my view, investments in the rupee bond market, both G-sec and corporate bonds, should be freely allowed for the following reasons:
 - i. Any ceiling has a negative connotation and dissuades intending investors.
 - ii. Given the huge fund requirements of the infrastructure sector, there is obviously a need to lengthen maturities in the bond market, and broaden the base of investors, particularly longer term investors like pension funds.
 - iii. Throwing open the bond market gives a strong signal to investors.
 - iv. The entry of large FIIs in the bond market would help improve the infrastructure and systems as has occurred in the equity market.
 - v. Most of the risks – exchange and interest rate – are with the investor.

It can be argued that, in the current, limited liquidity in the bond market, FII entry has the potential to create volatility in exchange and interest rates. To mitigate this possibility, a lock-in period can be prescribed. This

would also help create a more balanced market as foreign investors would have to act counter-cyclically, in a market which is presently often unidirectional.

3. Recommendation IV.A.1, **facilities for residents to transfer capital** up to \$ 25,000 a year, for any purpose. I had disagreed with a similar recommendation in the 1997 report. This facility has been in existence for a few years now, but does not seem to have been used much. While the Committee has recommended an increase in the limit, I am not in agreement with the recommendation for the following reasons:

- i. The facility is aimed at giving an opportunity to domestic savers to diversify investments, admittedly one of the objectives of capital account liberalisation.
- ii. While the facility does not seem to have been used much so far, it could be used extensively in a different market scenario. Indeed, investor behaviour often exhibits a herd instinct and, since the facility was introduced, for much of the time, not only were the returns in the Indian market more attractive but the rupee also appreciated against the dollar, reducing the attractions of investments abroad. (Incidentally, this environment also attracted large inflows from FIIs.)
- iii. When there are pressures on the rupee, or a lack of confidence in the domestic economy for any reason, the direction of capital flows can surely reverse. FIIs may start going out; leads and lags would be reversed; and domestic savers will be tempted to transfer moneys abroad, particularly when such transfers are legal. The phenomenon of domestic investors not being very “patriotic” when their returns are threatened, has been witnessed in south-east Asian countries at the time of the 1997-98 crisis, and time and again in Latin American and African countries.
- iv. I imagine that there could well be a million residents capable of using the \$ 25,000 facility. In a crisis, the potential outflow, even under the existing limit, is thus \$ 25 bn! Such a capital flight can only put additional pressure on the exchange and interest rates and, to that extent, make countercyclical action by the central bank more difficult.
- v. The reversal of other capital flows also has the same impact, but, in my view, they provide substantial benefits to the general economy – through lowering the cost of capital; helping real investment, growth and employment; and generally improving the efficiency of financial intermediation.

In short, to my mind, the risk reward relationship of the facility for residents is skewed more on the risk side, with rewards limited to a narrow section. In the case of capital inflows as well, the risk of reversal is there but, in my view, the rewards outweigh the risk.

Yours faithfully,

Sd/-
A.V.Rajwade

Dissent Note on the Report on Fuller Capital Account Convertibility

By

Surjit S Bhalla (member of Committee)

July 26, 2006

I have signed the "Report on Fuller Capital Account Convertibility (FCAC)" (hereafter Report) because I believe that a move towards FCAC is necessary if India wishes to grow at a faster rate, and especially if it wants to achieve the Prime Minister's (and Planning Commission) target of at least 9 % GDP growth per annum. The Report recommends some useful measures in this regard; hence, my signature on the report. It was a privilege to have been involved in this exercise, and I am appreciative for the sometimes frank discussions that the Committee had on the important issue of FCAC.

This dissent note is written to emphasize my *differences* with the Committee, differences that span several major issues relating to FCAC. I believe the Report on many occasions misses the "big picture" fact that India is a much different economy, and that the world environment is considerably different, than when the original capital account committee report was written in May 1997. The Report's concentration on the micro-detail is so intense that, for example, in one paragraph, it recommends that the RBI create a desk-job for a relationship officer (Chapter 7). Apart from my questioning the need for such micro-detail, my dissent also stems from the fact that on several occasions (some are detailed below) the Report does not empirically substantiate its conclusions/recommendations, and when it does, the conclusions suffer from faulty, or questionable, logic.

My overall conclusion is that the Committee has tended to look at issues in a gradual, incremental manner. Some are forward increments, and on these there is no dissent. Some recommendations are in the nature of politically correct but economically wrong tokenism, and on such issues there is dissent. Some recommendations are grossly inconsistent with the broad thrust of the Report; on such issues, the dissent is not minor.

The need to be politically correct (and perhaps economically incorrect) has led to contradictory conclusions in the Report; further, the Committee refuses to recognize that there has been a major *structural* change in the Indian (and world) economy since 1997. This recognition implies that what was appropriate ("fuller") in 1997 may be barely incremental today; hence, if the recommended policies are part of a slow continuum incremental package, which they are, then they might be inappropriate for Indian needs, circa 2006.

One small example encapsulates fully the need, and nature, of my dissent. The Committee, in its own perception, makes a "bold" move by recommending that Indian residents be allowed to remit upto \$ 100,000 per year by the end of 2008-09. It is useful to recall that the 1997 Committee's recommendation was that this limit should have been reached fully 9 years earlier i.e. by 1999/2000. So, in a bid to reform, the Committee has actually regressed backwards. What the Indian resident *may* be allowed to remit, and that too in 2008/09, is about 30 % less in real terms than she was recommended to remit in 1999/00. This is surely *not* a move towards "fuller" capital account convertibility.

Capital account convertibility, especially its fuller version, implies movement towards a greater integration of the Indian economy with the rest of the world, a movement towards the loosening of controls on inward and outward capital flows. There are two major conclusions with regard to inflows and outflows that the Committee (and I) are in full agreement. First, that the exchange rate should not be allowed to be significantly overvalued, and thereby hurt the competitive nature of the economy; second, that in terms of inflows, short-term debt is to be avoided and/or kept to a minimum. What is unfortunate is that the Report, via the eventual effect of its recommendations, violates either one, or both, of these commandments. This is detailed below.

Reserves, and exchange rate management: The report states that the exchange rate has been well managed in the last few years, etc. Yet the report also recommends that the RBI should be *constrained* to operate the exchange rate in a band of + - 5 percent around the REER; and when the REER moves beyond the band, the RBI "*should* ordinarily intervene" (para 5.14, emphasis

added). Examination of the various series on REER maintained by the RBI (different country combinations, different base years) shows that the Indian rupee has moved in a very narrow REER band for the last 14 years. The reason for this “constancy” is that the rupee has been *managed* by the RBI; the RBI has implicitly “forced” the rupee not to deviate from the real 1993/94 level.

Given that the rupee management has fulfilled every explicit requirement of the Committee’s objectives, then why does the Committee recommend a rigid rule for FX management, especially when countries have moved away from such rules in the last 10 years, and especially since the East Asian crisis of 1997?

The Committee’s decision to mandate a band is untenable, and surprising. A band would just be a ‘gift’ to speculators. What the Committee is implicitly assuming, given the pattern of exchange rate movements, is that the exchange rate selected in 1993/94 is sacrosanct and was a perfect 10 i.e. the nominal (real) exchange rate conceived in 1993/94 is appropriate for all time to come! In a globalized world, competitor exchange rates are also relevant; and over the last decade, the Indian rupee has appreciated relative to the Chinese yuan, and consequently, Indian competitiveness has suffered. Part of the large success of the Chinese economy can be attributed to a very undervalued (“cheap”) exchange rate. In this environment, to be fixated on our 1993/94 level of the real exchange rate, is inappropriate, and without reason, or empirical support.

The Report makes several other conceptual errors with regard to the exchange rate rule that it recommends. For example, the Report states that “the articulation of the exchange rate policy, however, gives the Committee some concern” (para 5.12). This articulation is in terms of volatility of the exchange rate whereas according to the Committee, what is “more important is the level of the exchange rate”. Since volatility is a change in levels, it is not clear what the Committee’s concern about “articulation” of policy is about, nor is it clear why articulation is so important, and nor is it clear why the Committee was not able to see the large presence of “levels” in calculations of “volatility”.

In conclusion, my view is that the RBI has shown itself to be capable of handling FX movements – when it ain’t broke, you shouldn’t fix it, especially by a method that is guaranteed to break what you are trying to preserve.

Capital Inflows

There are severe restrictions on capital inflows into India. Non-resident Indians (NRIs) are theoretically allowed to directly invest into Indian equity markets, but as the Report itself notes (para 2.12), there are severe RBI mandated impediments to such investments. With the effect that there is practically zero direct investment by NRIs into Indian equities, and Indian banks actively discourage the opening of NRI accounts (for investment in the stock market). This reality means that India is unique in the world in effectively banning its own (foreign based) citizens from directly participating in their own stock market. What this means is that if an Indian citizen is based in New York, she is *forced* to open an account with a non-Indian firm in New York, in order to buy some shares of SAIL and BHEL.

The present rules make very little sense. One remedy is that the NRI be allowed, via a rupee account, to directly invest into Indian securities (via SEBI regulated entities). However, the implementation of this much needed policy is recommended to occur, at best, in the second phase (2007 to 2009). Given the experience of the last capital account convertibility report, any *initial* action that is in Phase II or Phase III is a code word for saying “we really don’t want this action to be implemented”.

Thus, at present (and if the Report has its way, in the foreseeable future) non-resident Indians cannot directly invest in the Indian stock market. And non-resident foreigners (NRFs) cannot invest either i.e. all foreign-based individuals (and corporates) are prohibited from directly accessing the Indian market. All investment into Indian equities *has* to come via FII flows; an Indian, cannot by definition, be an FII. Most unfortunately, the Committee did not recognize this simple reality: by endorsing a continuation of a ban on direct investments into Indian equities, the Committee endorses the policy that the employment, incomes, and taxes generated from foreign

investment (FII flows) should not accrue to any Indian entity but rather should be gifted to foreign corporates and foreign governments. In the last year, it is estimated that some Rs. 10,000 crores of business income tax revenue accrued to foreign governments, instead of, perhaps rightfully, the Indian government. The Committee recommends that such gifts to foreign governments be continued, possibly indefinitely. I strongly dissent.

Non-resident investments in India and use of Participatory Notes (P-Notes)

All things considered, both the non-resident foreigner and Non-resident Indian pay a hefty premium to a firm which has managed to get the *license* to operate in the Indian stock market i.e. an FII. Instead of moving towards decreasing these transaction costs, the Committee recommends two actions that will further increase these costs: first, by delaying entry of individuals into the Indian market until 2008/9, and second by recommending a ban on Participatory notes or P-notes. The license raj has shifted from the industrial sector to the financial sector. Instead of reforming this “license raj”, the Committee, by recommending a ban on P-notes, is recommending a significant move backwards.

So as water finds its way, so do investors. The report reveals a lack of understanding of the underlying fundamentals, and reality, of stock market transactions. It is the bans and controls on investment by foreign based individuals and corporates that has created the off-shore P-notes market in Indian securities. P-notes primarily exist because of the large transaction costs that the Indian system imposes on foreign residents and corporates, and because of higher capital gains taxes in India than in other emerging markets. Most important, comparator emerging markets have zero short and long term capital gains taxes. (India has a 10 % tax on short-term gains and a 33 percent tax rate on short-term gains made via futures markets. Unfortunately, the Report did not deem it appropriate to discuss the influence of such differential tax rates on human and investment behavior).

Regrettably, P-Notes (an appropriate response to controls) is considered by the Committee to be of such an undesirable nature that it is recommended that they be banned immediately. That this might be a “politically correct” conclusion, at least in some institutions in India, is irrelevant. Like the FCAC committee, the government of India had also constituted an expert group to look at the issue of “Encouraging FII Flows and checking the vulnerability of capital markets to speculative flows”. This GOI report was published in November 2005; it reached the *opposite* conclusion on P-Notes than that reached by the FCAC Committee.

The Committee’s haste towards an immediate ban of P-Notes, and immediate reversal of existing Gol policy, *without any documentation or evidence*, suggests an ideological bureaucratic predisposition. And is in complete contrast, and perhaps out of character, with the Reports endorsement of a new policy, with *immediate* implementation, of industrial houses owning commercial banks – a policy, incidentally, I support. My only issue is that the Report is *inconsistent* in its recommendations. The recommendation on industrial houses does not come with any strings attached – somewhat surprising, given the extreme “caution” with which the report proceeds on other matters.

FCAC Report will encourage short-term debt inflows:

There are three problematic inter-linked Committee’s decisions: the ban on P-Notes, the effective ban on foreign based individuals from investing directly in the Indian market, and the introduction of Indian bank dollar deposit schemes for foreign residents. Dollar deposit schemes will only succeed if the Indian banks provide considerably higher returns to investors than what the investor obtains in his home country bank e.g. USA.

Two of the Committee’s recommendations are an endorsement of what prevailed in Thailand prior to the East Asian crisis, and have been noted by most observers (including implicitly the Report) to have been a major cause of the crisis. Prior to June 1997, Thailand was operating a fixed exchange rate, and high interest rates on dollar deposits. This was a free gift to foreigners: borrow at low rates in the US, invest in Thailand at higher rates, and not have any exchange rate risk. The FCAC committee has recommended something very similar (and I strongly dissent). It recommends a narrow band for the exchange rate to move, and offers higher interest rates, and no permission to convert dollar deposits into rupee assets. In effect, what the Committee is

saying is that we are very comfortable with short-term dollar deposits, but not at all comfortable with these deposits forming part of the savings pool of Indian firms.

The rest of the Report takes an opposite position. In several parts of the Report, it is mentioned how short-term dollar debt is the most problematic of foreign inflows, how short-term debt was one of the causes of the East Asian crises, etc. These conclusions I agree with; which is why I strongly dissent with the Committee's implicit endorsement of more short-term dollar debt for India, and the Committee's explicit recommendation to not transform such dollar debt into rupee debt, and even better, into rupee assets.

Some other problems with the Report

There are other not so major problems that I have with the report. It seems to be excessively pre-occupied with the size of the fiscal deficit, and less concerned than it should be about the integration of India's taxation policies with that of its competitors. It is more concerned about scoring narrow "moral" points than being pragmatic about what maximizes tax revenue. It is more concerned about the fiscal deficit than about runaway expenditures.

There is a part I strongly agree with, but an issue which the Report does not openly discuss i.e. the need for greater autonomy for the Reserve Bank of India. The Report's concerns are so covered in generalities and platitudes that a reader can be excused if she infers that the Report is recommending business as usual. The move towards FCAC was an ideal time to argue for considerably greater autonomy for the RBI; it is a pity that the Committee chose to heavily mask its view.

I had also written a dissent note (a much smaller one) in 1997. It is relevant to recall the issue involved – opening up of the Indian borders to portfolio *outflows*. This is what the 1997 Report said (p. 120), "Another member, Dr. S.S. Bhalla, held a contrary view and in his assessment the macro economic situation was unprecedentedly strong. In fact he felt that as the country is likely to continue to experience large capital inflows, better macro and exchange rate management would be facilitated if individual residents were allowed outflows with significantly larger limits". I just hope I am as prescient, and accurate, with my present dissent as I was with my 1997 dissent.

Finally, I want to register a complaint against an implicit assumption of the FCAC committee (and other government Committees that I have had the privilege of being a member) i.e. that the committee's report should be cognizant of so-called political realities and prejudices. In my view, a committee is not doing justice to its selection if it is constantly anticipating the reaction of politicians, bureaucrats and policy makers. An expert committee report should be objective, even if it means that none of the recommendations are accepted. A failed Report might be the biggest sign of its success.

Sd/-
(Surjit S Bhalla)
July 26, 2006